

DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBERS: 03-0461; 04-0135; 04-0136
Corporate Income Tax: Accounting Methods
For Tax Years 2000 & 2001

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ISSUE

I. Corporate Income Tax: Accounting Methods

Authority: IC § 6-3-1-3.5; IC § 6-3-2-2(a)(2); IRS Publication 538; 26 CFR § 1.451-5(b)

Taxpayer protests the audit's assessment of additional taxable corporate income, arguing that deposit amounts taken for items not in taxpayer's inventory were incorrectly included in the audit adjustment.

STATEMENT OF FACTS

Taxpayer, a subchapter S corporation, is a retailer of in-ground spas and hot tubs. Originally, taxpayer protested issues in three separate files. During the telephone hearing, taxpayer indicated two of the three protests had been resolved. Therefore, the sole issue still remaining is the one outlined *supra*: the audit assessment of additional taxable income. When a customer wishes to purchase a spa or hot tub not in taxpayer's inventory, taxpayer accepts an advance payment or deposit, orders the spa or hot tub from the manufacturer, and then delivers and installs the spa or hot tub, whereupon the taxpayer collects the remainder of the money owed. Taxpayer uses the accrual method of accounting in keeping his books, and for income reporting purposes. Additional facts will be supplied as required.

I. Corporate Income Tax: Accounting Methods

DISCUSSION

Taxpayer protests the audit assessment of additional taxable corporate income, arguing that deposit amounts were incorrectly included in the audit adjustment. Taxpayer uses the accrual

method of accounting and argues that the deposits are not taxable until delivery is complete and services are performed. Taxpayer supports his argument by stating that since he uses the accrual method of accounting, any deposits customers make on spas and/or hot tubs that are not in his inventory and therefore must be ordered from the manufacturer are not taxable until the items are delivered and installation services are completed. The audit relied on Internal Revenue Service (IRS) Publication 538; the audit report provides in pertinent part:

IRS Publication 538 which states that an amount becomes part of gross income for the year in which all events that fix the merchant's right to receive the income have occurred and the amount owed can be reasonably determined. Under this rule, the amount is reported in gross income when the income amount is due the merchant. In this case the deposits are partial payments of the final agreed upon purchase price of the transaction.

Taxpayer contends that the corporation is reporting income under the accrual method of accounting and that the inclusion of deposits accepted as down payments on noninventory spas and hot tubs should not be included in gross receipts in the year the down payment is accepted because these advance payments are for items taxpayer orders from a manufacturer; they are not inventoried goods. Taxpayer has reported income using the accrual method since 1997; both the state of Indiana and the federal taxation schemes allow taxpayers to use either the cash method of accounting, or the accrual method of accounting; both are correct, and, moreover, legal. Taxpayer's representative sent the auditor a letter setting forth his argument, stating there was no underreporting of income to the state of Indiana; it was merely a question of timing.

IC § 6-3-2-2 defines, at great length, the adjusted gross income tax. Subsection (a)(2) describes the income at issue in this protest: "income from doing business in this state." For purposes of Indiana's adjusted gross income tax, a taxpayer must begin with the federal income tax code's definition of "adjusted gross income," with certain add backs and deductions. *See* IC § 6-3-1-3.5.

IRS Publication 538 defines the accrual method of accounting as one where a taxpayer reports "income in the year earned and [deducts] or [capitalizes] expenses in the year incurred. The purposes of an accrual method of accounting is to match income and expenses in the correct year." The publication goes on to state:

You generally include an amount as gross income for the tax year in which all events that fix your right to receive the income have occurred and you can determine the amount with reasonable accuracy. Under this rule, you report an amount in your gross income on the earliest of the following dates

- When you receive payment
- When the income amount is due you
- When you earn the income

Until the transaction is complete, either through delivery and installation and payment, or default, taxpayer cannot determine income “with reasonable accuracy.” Moreover, as the materials cited *supra* support, noninventory goods under the accrual method of accounting and reporting allow taxpayer a choice in the timing of reporting the income.

FINDING

Taxpayer’s protest concerning the audit assessment of additional taxable corporate income, based on the accrual method of accounting for noninventoried goods, is sustained.

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